

**MINUTES OF THE REGULAR MEETING OF THE
ARIZONA STATE RETIREMENT SYSTEM BOARD**

**HELD ON
March 21, 2003
9:30 a.m., MST**

The Arizona State Retirement System (ASRS) Board met in the Conference Room, 7660 E. Broadway Blvd., Suite 108, Tucson, Arizona. Mr. Alan Maguire, Chairman, Arizona State Retirement System Board, called the meeting to order at 9:34 a.m., MST.

The meeting was teleconferenced to the ASRS office at 3300 N. Central Avenue, Phoenix, Arizona 85012.

1. Call to Order; Roll Call, Opening Remarks

Present: Mr. Alan Maguire, Chairman
Ms. Charlotte Borchert
Mr. Jim Bruner
Dr. Chuck Essigs
Mr. Norman Miller (via telephone)
Mr. Karl Polen (via telephone)
Mr. Ray Rottas
Mr. N. Carl Tenney

Excused: Ms. Bonnie Gonzalez

Also Present: Mr. Steven Zeman, Nominee
Dr. Keith Meredith, Nominee
Mr. Lawrence Trachtenberg, Nominee (via telephone)

A quorum was present for the purpose of conducting business.

2. Presentation, Discussion and Appropriate Action of ASRS Services and Benefits

Mr. Anthony Guarino, Deputy Director, Chief Operations Officer, gave an introduction.

Ms. Michelle Briggs, Employer Relations Manager, provided a historical and statistical overview on the ASRS, as well as the services and benefits it provides.

3. Presentation, Discussion and Appropriate Action of ASRS External Affairs Quarterly Briefing Including Contribution Rates

Mr. Richard Stephenson, Deputy Director, External Affairs, discussed the responsibilities of the External Affairs (EA) Division at the ASRS. He also provided an update on the activities of the division over the past quarter.

EA serves employers and meets with their human resource department regularly to help explain processes and procedures. EA is currently planning another employer conference, as well as workshops to help retirees and new employer staff training.

The communications section of EA has redesigned the ASRS newsletter, fact sheets, and the Web site so that it is more reader and user-friendly. The ASRS has also increased its number of appearances in national publications.

Additionally, EA is responsible for reviewing existing and developing new rules to govern the procedures of the ASRS. These rules will soon be brought to the Board for consideration.

There were 18 bills introduced in the Legislature this year. The ASRS provides a weekly report to keep employers and members up-to-date on the status of these bills. There have been an increased number of requests for calculations from the Actuary regarding the impact of proposed legislation on the System.

Mr. Stephenson discussed the increase in the contribution rate for the next fiscal year. Due to remarkable returns from the market over the past 12 years, the contribution rate has been able to remain at a low level. During the time when members and employers each paid two percent, other systems were paying nine percent. However, given the decline in the market and the increased benefits by the legislature in the past few years, the cost will increase to a more normal level. These rates will more than likely continue to increase.

4. Presentation, Discussion and Appropriate Action of the ASRS Plans in Relation to the ASRS Budget

Mr. Guarino provided the background behind the ASRS budget request. The goal of the ASRS is to be one of the nation's leading retirement plan administrators and financial services institutions by the year 2007. Benchmarking studies have indicated that the ASRS currently provides average services but at a very low cost. Some of the operational goals of the ASRS are to facilitate access to education, account information, communications, and services.

The ASRS budget request is in two parts. One is the Information Technology (IT) Plan, which will drive the improvement in services and accessibility. The other part is the Operations part to support the goals and staff the projects. The Joint Legislative Budget Committee (JLBC) recommended reductions in the ASRS request, but the ASRS has offered a revised request. The proposed reductions could impact timely services, staff retention, changes to the health insurance program, the progress of the IT plan, and communications.

5. Presentation, Discussion and Appropriate Action Regarding the Protection and Investment of ASRS Assets

Mr. Gary Dokes, Acting Chief Investment Officer, explained that as of February 28, 2003, the ASRS' total assets were \$16.6 billion. The ASRS' main investment goals include retaining safety as a principal consideration, achieving the actuarial investment rate of return of eight percent, maintaining a minimum funded status of 100%, supporting excess earnings in the Permanent Benefit Increase, and maintaining a stable contribution rate.

Mr. Dokes further expressed the importance of determining the ASRS' Asset Allocation Policy as it is the most important decision made in managing the ASRS portfolio. Asset allocation is estimated to account for 80-90% of the ASRS' total fund return. Manager selection, the manager's security selection, and market timing decisions account for only 10-20% of the total fund return.

6. Approval of Minutes of the February 21, 2003, Regular Meeting of the ASRS Board

Motion: Dr. Chuck Essigs moved to approve the minutes of the February 21, 2003, Regular Meeting of the ASRS Board.

Ms. Charlotte Borchert seconded the motion

By a vote of 8 in favor, 0 opposed, and 0 abstentions, 1 excused, the motion was approved.

7. Approval of the Consent Agenda

Motion: Dr. Chuck Essigs moved to approve refunds, death benefits, retirements, system transfers, and applications and agreements with Tertulia Charter School and Paramount Education Studies, Inc.

Ms. Charlotte Borchert seconded the motion.

By a vote of 8 in favor, 0 opposed, and 0 abstentions, 1 excused, the motion was approved.

8. Presentation, Discussion and Appropriate Action Regarding the Extension of the Following Contracts
A. CB Richard Ellis
B. TIAA CREF

Motion: Dr. Chuck Essigs moved to approve the contract extension of CB Richard Ellis to manage and lease the 3300 Tower and Broadway Proper properties to June 30, 2004, and contract extension of TIAA CREF for the Supplement Retirement Savings (401(a)) Plan administration to June 30, 2004.

Ms. Charlotte Borchert seconded the motion.

By a vote of 8 in favor, 0 opposed, and 0 abstentions, 1 excused, the motion was approved.

9. Presentation, Discussion and Appropriate Action Regarding the Retention of Barclays Global Investors (BGI) as Investment Manager for Large Cap Passive Domestic Equity Asset Class

Motion: Dr. Chuck Essigs moved to approve the contract extension of Barclays Global Investors for the Large Cap Passive Equity mandate to June 30, 2004.

Ms. Charlotte Borchert seconded the motion.

By a vote of 8 in favor, 0 opposed, and 0 abstentions, 1 excused, the motion was approved.

10. Director's Report

Mr. Paul Matson, Director, pointed out that the Internal Audit Department found no compliance issues pertaining to investments.

With regard to the search for an additional attorney for the ASRS, staff has been working with the Arizona Attorney General's office and will be interviewing a candidate for the position.

Motion: Dr. Chuck Essigs moved to accept the Director's Report.

Ms. Charlotte Borchert seconded the motion.

By a vote of 8 in favor, 0 opposed, and 0 abstentions, 1 excused, the motion was approved.

11. Presentation, Discussion and Appropriate Action Regarding Fiduciary Responsibility

Ms. Nancy Williams, Attorney, Mercer Investment Consulting, identified all Board members as fiduciaries. Staff members, who have discretion and control over the administration of the plan or management of the assets are also fiduciaries. A person's fiduciary duty is limited to the scope of responsibility they assume. Ms. Williams further explained that one becomes a fiduciary by accepting a position on a Board covered by the Arizona state statutes, assuming certain responsibilities, even if not required by statute, and agreeing to fiduciary standards in a contract.

Mr. Ray Rottas inquired where the fiduciary duties lie with the Legislature versus the Board. Mr. Fred Stork, Assistant Attorney General, stated that under the Arizona Constitution, the Legislature has the responsibility to attend to the retirement fund in a way that does not inhibit

the function of the retirement fund. It is difficult to say where the line is drawn, but both have a responsibility.

Mr. Karl Polen asked what would happen if the actuary said the contribution rate should be one amount and the Legislature said it had to be another amount. Mr. Stork stated the Board needs to provide the Legislature with information. If the Legislature still will not change their decision, the Board will have to take action to protect the Fund and to keep the legislative decision from taking effect. Mr. Norman Miller asked if that meant taking the Legislature to court. Mr. Stork replied that there is no precedent for this in Arizona but added that this has happened in other states.

Ms. Williams further discussed the different standards that trustees should be held to. The Prudent Expert Standard establishes that trustees will be judged by those who serve in the same capacity as them and who act with the care, skill, prudence and diligence, under the circumstances then prevailing that a prudent (expert) (person) acting in a like capacity and familiar with such matters would use in the conduct of an enterprise to like character and with like aims. The Prudent Expert Standard is the highest standard, so it is the standard to comply with.

Mr. Stork stated that the Legislature has set it up so that the Board is not responsible for the performance of the Fund, and a Board member is not liable civilly unless damage was willful, wanton, grossly negligent conduct.

Further, Ms. Williams explained that the Board has fiduciary duty to be equitable and fair in disbursements with regard to investments and benefits administration. Prudence requires the exercise of judgment and duty to incur only reasonable expenses.

The ASRS owes loyalty to all beneficiaries. There is no fiduciary duty to the appointing authority. Nor can there be any favoritism shown to a subgroup of members. The trustees' duty is not to balance the interests of the State or the taxpayers or to please everyone who wants something from the System but to act solely in the interest of the beneficiaries.

The standards are very high when it comes to conflicts of interest. Trustees should avoid self-dealing and self-enrichment as the courts are very strict on fiduciaries. Additionally, trustees may have co-fiduciary liability if they fail to speak up if someone is breaching their duty.

The Board is somewhat protected from liability when they rely on experts, provided they were prudent in their selection and oversight of the experts. They may also have governmental immunity if the state provides for it. One way to avoid liability is by continuing education. Another way is to maintain clear documentation of Board action.

Mr. Miller inquired as to the fiduciary's responsibility with regard to shareholder activities. Ms. Williams replied that the Board has the duty to vote the proxies and should have a proxy policy as well as a record of how proxies were actually voted. Beyond this activity, some other public retirement funds believe more is required of them, if the activities they undertake improve the value of the shares they own in a corporation.

12. Presentation, Discussion and Appropriate Action Regarding Fiduciary Responsibility with Respect to the Arizona State Statutes

Agenda Items #11 and #12 were discussed simultaneously.

Dr. Chuck Essigs excused himself from the meeting at 10:57 a.m.

13. Presentation, Discussion and Appropriate Action Regarding the Legislative Update

Ms. Kelly Orrick, Legislative Liaison, gave an update on bills in legislative session. The bill pertaining to the rural subsidy (SB 1036 & HB 2349) has passed the Senate and has been triple assigned in the House. The House version of the bill was first amended to do a 10% reduction in the first year and a 15% reduction in the second year. When this bill got to the floor of the House it was amended again to remove the rural subsidy extension all together. Language was inserted that said retirees would be eligible to rejoin their former employer's health insurance plan. The exemption to that was anyone who had the opportunity to stay in their prior employer's plan and opted not to at the point of retirement. Employers are concerned about this exemption.

The Senate bill pertaining to health insurance for survivors (SB 1037) is moving well through the process. It has been amended to replace some technical language. An administrative cost needs to be attached. The Information Technology area has identified additional costs to have these changes programmed into the system.

The Contributions Not Withheld Bill (HB 2026) has passed the House. It has been passed by Senate Finance Committee. The Service Purchase bills are doing well.

The terrorism funding bill (SB 1296, HB 2397 & HCR 2029) has been amended to radically alter the requirements. The Office of Foreign Assets Control, an office within the Department of Treasury, publishes a list of companies that have been identified by the Federal government as being involved in supporting terrorism and exempt from doing business with anyone in the United States as a matter of federal law. The bill requires the ASRS' investment managers to ensure they are in compliance with these laws. According to Mr. Stephenson, the language in the modified bill today would be acceptable to the Board except for the reference to company "subsidiaries" that will yet need to be removed.

14. Presentation, Discussion and Appropriate Action Regarding Fixed Income Manager, Western Asset Management Company (WAMCO)

Mr. Karl Polen, Chairman, Investment Review Committee, explained that the market value of the portfolio managed by WAMCO has declined such that it impacts the manager's ability to effectively manage active risk positions within desired tracking error parameters. As of February 21, 2003, the market value of WAMCO's portfolio was \$205 million. A fixed income portfolio size of less than \$400 million for a fund the size of the ASRS is considered to be less than optimal.

It was recommended to transition the WAMCO account assets to cash, equitized cash, or fixed income securities. It was further recommended that WAMCO not be terminated but designated as a backup active fixed income manager.

Motion: Ms. Charlotte Borchert moved to de-fund Western Asset Management Company but to retain them as a backup manager for the ASRS fixed income portfolio.

Mr. Jim Bruner seconded the motion.

By a vote of 7 in favor, 0 opposed, and 0 abstentions, 2 excused, the motion was approved.

15. Presentation, Discussion and Appropriate Action Regarding Domestic Equity Managers

A. Forstmann-Leff (Mid Cap Growth)

B. Frontier Capital Management (Mid Cap Growth)

Mr. Karl Polen stated that Forstmann-Leff and Frontier Capital Management were asked to report to the Board because both of these managers have under performed since inception in June, 2002.

Forstmann-Leff Associates

Mr. William F. Harnisch, CFA, President & CEO, and Ms. Joelyn Flomenhaft, Director of Client Relations, presented for Forstmann-Leff Associates. Ms. Flomenhaft stated during the first six months Forstmann-Leff lagged the benchmark but have begun to outperform since the beginning of the year.

	Year-To-Date	Since Inception
Net Return*	0.74%	-22.16%
Benchmark Return**	-4.96%	-14.65%
Total Value Added Relative to Benchmark	5.70%	-7.51%

*The inception date of the portfolio is July 1 2002. Past performance is not indicative of future results. Performance data is calculated after (net) the deduction of management fees and reflects the reinvestment of all interest and all realized and unrealized gains and losses.

**Total return reflects interest and dividends reinvested. Benchmark utilized as per advisory agreement.

Mr. Harnish explained that an economic recovery is expected by the second half of 2003. Additionally, there is opportunity for multiple expansions in growth stocks that can meet or beat earnings estimates. The structure of the portfolio will be very stock specific, focusing on companies with consistent growth and cyclical growth.

Frontier Capital Management

Mr. John Higgins, Senior Vice President, Portfolio Manager, presented for Frontier Capital Management. Mr. Higgins explained that Frontier is patient with their investments unless something a company is doing is fundamentally wrong. He added that Frontier has consistently outperformed and expect this to continue.

Net Return	1st Qtr 03 (Thru 2/28)	4th Qtr 02	3rd Qtr 02	Inception (6/30/02)
Frontier MidCap	-4.30%	6.49%	-21.13%	-19.62%
Benchmark Return	-4.97%	5.12%	-14.56%	-14.65%
Total Value Added Relative to Benchmark	0.67%	1.37%	-6.57%	-4.97%

Mr. Higgins explained that the primary performance issues have been negative stock selection in the consumer discretionary sector due to the conflict in Iraq. Financial services is the other area of negative stock selection. Technology stock selection had been a problem area in summer 2002, but technology stock selection turned positive in the past several months.

Frontier believes that expectations for 2003 are now realistic. Assuming an acceptable outcome in the Iraqi conflict, consumer spending is expected to stabilize as well as business capital spending.

In the short term, Frontier expects to add value primarily by producing positive stock selection. Frontier's investment process works best during an improving economy. In the long term, Frontier expects to identify sector leadership driven by improving long-term business fundamentals as the current global uncertainty stabilizes.

16. Presentation, Discussion and Appropriate Action Regarding the Board Governance, Organizational Development Search Award

This agenda item was held until the end of the meeting so that the Board could convene to Executive Session.

17. Presentation, Discussion and Appropriate Action Regarding Term of the Board Chairman and Vice Chairman

Mr. Alan Maguire stated that a number of years back the term of the Board Chairman and Vice-Chairman ran from January 1 of each year through December 31 of that same year. Approximately four or five years ago the term was changed so that it could coincide with the fiscal year financial report. The Board member's terms now run from January through

December. This will sometimes cause the Chairman's term to expire during his or her Chairmanship.

Motion: Ms. Charlotte Borchert moved that commencing from and after December 31, 2003, the term of the Chairman of the Board and the Vice-Chairman of the Board shall run from January 1 of each year through December 31 of that same year.

Mr. Jim Bruner seconded the motion.

By a vote of 7 in favor, 0 opposed, and 0 abstentions, 2 excused, the motion was approved.

18. Presentation, Discussion and Appropriate Action Regarding Criteria for Selection of Board Chairman and Vice Chairman

Motion: Ms. Charlotte Borchert moved that the Chairman and Vice-Chairman shall be nominated and elected at the December meeting of each year for the term of the upcoming calendar year. The nomination shall be from among those members of the Board whose current term of appointment extends through the upcoming calendar year and who have demonstrated diligent service while on the Board on behalf of the ASRS.

Mr. Carl Tenny seconded the motion.

By a vote of 7 in favor, 0 opposed, and 0 abstentions, 2 excused, the motion was approved.

19. Election of Officers

Motion: Mr. Jim Bruner moved to nominate Mr. Karl Polen to serve as Chairman of the Board and Mr. Norman Miller to serve as Vice-Chairman of the Board. Their terms of office to commence upon confirmation of the new Board members appointed to succeed the current Chairman and the current Vice-Chairman. These terms will continue through December 31, 2003.

Ms. Borchert seconded the motion.

By a vote of 7 in favor, 0 opposed, and 0 abstentions, 2 excused, the motion was approved.

20. Board Requests for Agenda Items

None.

21. Call to the Public

Mr. Bill Peltier noted that the website is not Mac friendly and asked if the ASRS could make the website accessible from a Mac computer.

Mr. Tom Dozier, Teacher and Certified Financial Planner, requested the Board to pressure the Legislature to rescind the enhanced benefits because of the effect on the increased contribution rates. It may benefit retirees, but it is hurting current school districts because there are no pay raises to complement the higher contributions. The school districts will also need to take other measures to cover the increased costs to them. Mr. Dozier believes it will also have an impact on the System assets. Any surplus will be taken away and it puts the Fund at risk.

Mr. Uwe Fink, requested that more meetings be held in Tucson and that these meetings be held in the same distribution as the population of members (7 in phoenix, 3 in Tucson, and 2 in other areas of the state). He is also a member of the System and wondered if members of the System could participate in the rule development and have input before it comes to the Board. Finally, Mr. Fink commented on the positive performance in the investment area.

Mr. Robert Letson expressed concerns about the fact that the Board committees do not really solicit input from the members as they make decisions. He believes the members should have more participation with the Board and staff so they can be better informed.

Motion: Mr. Jim Bruner moved to convene to Executive Session at 12:55 p.m.

Ms. Borchert seconded the motion.

The Board reconvened to Regular Session at 1:10 p.m.

16. Presentation, Discussion and Appropriate Action Regarding the Board Governance, Organizational Development Search Award

Motion: Mr. Jim Bruner moved that the Board authorize award of the contract for Board Governance Policy Development and Training as recommended by the Ad Hoc Board Governance and Organizational Development Request for Proposal Evaluation Committee to Mercer Investment Consulting, subject to the negotiations of fees, terms and conditions.

Ms. Borchert seconded the motion.

By a vote of 7 in favor, 0 opposed, and 0 abstentions, 2 excused, the motion was approved.

22. The next ASRS Board meeting is scheduled for Friday, April 18, 2003, at 8:30 a.m. in the 10th Floor Board Room of the ASRS Offices at 3300 N. Central Avenue, Phoenix, AZ 85012

23. Adjournment of the ASRS Board.

Mr. Alan Maguire, Chairman, adjourned the March 21, 2003, meeting of the ASRS Board at 1:14 p.m.

ARIZONA STATE RETIREMENT SYSTEM

Marina Chaves, Secretary

Date

Paul Matson, Director

Date